Subject Index

	Page
Question presented	1
Reasons for denying the writ	2
1. The decision is not in conflict with Lucas v. Earl	2
2. The decision below does not apply any rule respecting the taxation of partnership income	9
3. The decision below has no significance with respect to the taxation of deferred compensation arrangements generally	10
4. "Administrative importance" is not a ground for certiorari	11
Conclusion	12

Table of Authorities Cited

Cases

	Pages
Hulbert v. Commissioner (7 Cir., 1955) 227 F.2d 399	8
Lucas v. Earl, 281 U.S. 111	2, 3, 5, 6, 8, 9
Nicholas A. Stavroudis, 27 T.C. 583	8
Paul A. Teschner, 38 T.C. 1003	8

Codes

Internal Revenue Code:	
Section 401	10
Section 402(b)	10

Regulations

Treasury Regulation, 1.402(b)1(a)	10

In the Supreme Court
OF THE
United States

OCTOBER TERM 1971

No. 71-1022

UNITED STATES OF AMERICA,
Petitioner

VS.

JAMES A. BASYE AND EVELYN E. BASYE, et al.,
Respondents

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit

QUESTION PRESENTED

In our view, the petition begs rather than articulates the question presented. The retirement plan here at issue was unique, as were the nature and relationship of the parties who established it. The question raised by the case can only be stated in terms of its special facts.

The precise question is whether moneys paid by Kaiser Foundation Health Plan, Inc.[1] into a physicians' retirement plan, established for the purpose of insuring Kaiser a stable and reliable pool of physicians providing medical services to its members, constituted current distributable income to the medical partnership whose contract with Kaiser provided for payments into the plan, despite the fact that such payments were not otherwise available to the partnership or to the individual members thereof, but were paid *solely* to fund the retirement plan.

REASONS FOR DENYING THE WRIT

1. THE DECISION IS NOT IN CONFLICT WITH LUCAS v. EARL

By omitting certain key facts from its statement of the case, and by assuming the facts to be otherwise in its phrasing of the "question presented," the government's petition seeks to make it appear that the decision of the Court of Appeals has departed from the principle of *Lucas v. Earl*, 281 U.S. 111.[2] That case held that one may not escape the tax on his earnings by anticipatory assignment thereof to another.

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[1]We will refer to Permanente Medical Group partnership as "Permanente" and to Kaiser Foundation Health Plan, Inc. as "Kaiser," as did both the District Court and the Court of Appeals, although the government's petition uses the terms "Medical Group" and "Health Plan."

[2]In contrast to its current view that this case "impairs the integrity" of a "cornerstone in the structure of the income tax law," the government briefs to the Court of Appeals made but a single reference to *Lucas v. Earl*, in a footnote which stated that while analogous, it "need not be relied upon to support the government's position here." (App.Op.Br., fn. 29, p. 34.)

If this were such a case—if the Permanente Medical Group had simply contracted in advance to have earnings which would otherwise have been available to it paid instead to a trustee to fund this retirement plan—then the *Lucas v. Earl* doctrine might indeed apply. But this is not such a case.

This case was presented to the trial court on the basis of a written agreed statement of facts. That agreed statement eliminated any factual basis for application of the anticipatory assignment of income doctrine of *Lucas v. Earl*. In a portion of the agreed statement which the petition disregards, it was stipulated that "The payments which Health Plan agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof."[2]

Both the District Court and the Court of Appeals understood the meaning and significance of that fact. Thus, after quoting that portion of the agreed statement, the Court of Appeals said:

> Furthermore, the Medical Service Agreement between Permanente and Kaiser provides that in the event Permanente establishes a retirement plan approved by Kaiser, Kaiser's contributions to the plan are to be *in addition* to all other sums payable by Kaiser. Thus, had Permanente elected not to establish the retirement plan, it could not have received additional current income. Nor is there any evidence in the record to suggest that

[2]Agreed Statement of Facts, ¶16, p. 7, lines 18-21, I-R 42:18-21 The Transcript of Record in the Court of Appeals consisted of three volumes, which will be cited herein as I-R, II-R and III-R.

> Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. That Kaiser would not have been willing to make the payments except into the trust under the conditions imposed is consistent with the primary purpose of the retirement plan: to insure Kaiser a stable and reliable group of physicians. The payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians. When the transaction is viewed in this light, the partnership becomes a mere agent contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a principal which itself realizes taxable income. We therefore conclude that Permanente, never having had the right to receive the income, could not have diverted it to others.
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> (Pet., App. B, 40.)

Under the terms of the plan, its eventual beneficiaries were not the partnership, nor its partners as such, but "participants." Whether a qualifying physician was or was not a partner in Permanente had no bearing on his status as a participant. (I-R 133, 139.) Employed physicians had precisely the same standing and status as partners. Furthermore, a participant would forfeit his rights only upon ceasing to serve Kaiser members, *not merely by leaving the partnership.* Any participant (employee or partner) leaving the partnership to join another Kaiser-affiliated physician group would take his contingent interest with him. (Plan, Article H-1, I-R 148-149.)

The significance of these provisions is simply that the plan's terms, as well as its original purpose, served the interests of Kaiser; it was designed to induce physician loyalty to Kaiser, not to Permanente.

Thus the decision is not surprising or unusual, nor is it inconsistent with *Lucas v. Earl*. Once the facts are fully and fairly stated, it is apparent that Permanente did not "deflect" a portion of its income to the retirement plan. Neither individual partners nor the partnership could have received or benefited from Health Plan's contributions except in the form of contingent and forfeitable "tentative accounts" under the plan.

The law is very clear that the rights or prospects of participants in the Plan, as participants, were simply too contingent and uncertain to constitute currently taxable income. Indeed, the government has never contended that the rights of employee-participants achieved the level of taxable income, and no deficiencies were assessed against the employee-participants. The Court of Appeals held that such contingent prospects as were conferred upon participants under the plan did not constitute current taxable income to the participants qua participants.

> . . . had the taxpayers contracted individually with Kaiser for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made. This conclusion accords with the decisions of both the courts and the Internal Revenue Service holding that payments made into deferred compensation plans which include sub-

> stantial forfeiture provisions are not taxable until actually received or otherwise made available to the taxpayer, even though not qualifying for special treatment under §§401-404 of the Internal Revenue Code. See *Drysdale v. C.I.R.*, 6 Cir., 1960, 277 F.2d 413; *Schaefer v. Bowers*, 2 Cir., 1931, 50 F.2d 689; *Harold G. Perkins*, 1947, 8 T.C. 1051; *Julian Robertson*, 1946, 6 T.C. 1960; Rev. Rul. 67-449, 1967-2 Cum.Bull. 173.
>
> (Pet., App. B, 36)[4]

The statement of the "question presented" in the government's petition assumes what is not a fact, *i.e.*, that the payments were "compensation for services rendered by a medical partnership." (Pet., 2.) That statement of the question implies that Kaiser made payments into the plan in a given year in consideration for medical services rendered during that same year. That simply was not the fact. Kaiser's contributions to the plan were by the express terms of its contract with Permanente to be *in addition to* all other sums payable as compensation for medical services. (Medical Service Agreement, Sec. H-4, I-R 104, 105.) Since the beneficial enjoyment of those additional payments was forfeitable and contingent upon future events, they cannot be considered to be "compensation for services rendered," certainly not for medical services *currently* rendered. At most they could be considered compensation for continued future services of

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[4]The government's present attempt (Pet., 11-12) to distinguish the cited Tax Court cases on the ground that respondents were vicariously "compensated" through the partnership assumes the very question at issue—i.e., that the partnership should be regarded as having realized income because of the anticipatory assignment doctrine of *Lucas v. Earl*.

individual participants in the plan; it required this year's work plus many more before a physician might realize benefits from the contribution.[5]

The decision of the Court of Appeals is entirely consistent with the cases cited in the government's petition. All were cases in which, *but for* an anticipatory assignment or other contractual arrangement diverting or deflecting income to a third person, the *taxpayer would have received it.* But it was stipulated in this case that Permanente would *not* have received these moneys otherwise. The Tax Court has consistently refused to apply the anticipatory assignment doctrine to situations where the taxpayer, although his efforts may have in some sense produced or

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[5]In 1960, when Kaiser's first contribution was made, the six physician litigants in the instant cases were required to perform an aggregate of fifty-four years additional service to Kaiser's membership before they would be entitled to retirement benefits under the plan. See Chart, Appellee's Brief in the Court of Appeals, p. 9.

Furthermore, upon terminating her relationship to Kaiser in 1963, Respondent Nadia Sorokowski "forfeited all rights to receive any future payments from the trust." (I-R 46.) Dr. Sorokowski's case was not exceptional. During the years 1960-1963, twenty-three physicians (roughly ten percent of the participants) terminated their services to Health Plan's members and forfeited their "tentative accounts." (I-R 45; 180.)

Each of these "forfeitures" occurred prior to September 1963, when Dr. Sorokowski left Health Plan. (I-R 180.) Since every "forfeited" account is tentatively reallocated among the remaining participants (Article E-3-b, I-R 141), Dr. Sorokowski's account, at the point of her forfeiture, included her share of the twenty-three earlier forfeitures. This she in turn forfeited to the remaining participants. It is of course impossible to say how many further forfeitures will occur before the 1960-1963 contributions are actually realized by their ultimate recipients.

Under the rubric that "income must be taxed to him who earns it," the government contends here that Dr. Sorokowski, as well as all the other physicians whose prospects of benefits stood subject to forfeiture, "earned" taxable income each year by virtue of contributions to the fund, and must be taxed accordingly. It is difficult to believe that a "principal bulwark" of the tax structure requires that result.

"earned" the income, could not, even absent the contractual arrangement under attack, have himself received it. See, *e.g., Paul A. Teschner,* 38 T.C. 1003 and *Nicholas A. Stavroudis,* 27 T.C. 583, discussed in the opinion of the District Court (Pet., App. A, 22.)

The petition assails certain language in the Court of Appeals' opinion to the effect that *Lucas v. Earl* is not controlling because "Permanente never had the right to receive" Health Plan's contributions to the trust. The government urges that the same was true of Mr. Earl, in that, after the assignment of a part of his income to his wife, he no longer had the "right to receive" that income.

But that misses the point, because Mr. Earl had control over the receipt of his future earnings until he made the assignment to his wife. In contrast, neither Permanente nor any of the individual participating physicians controlled nor had any prospect of receiving the amounts which Kaiser ultimately paid into the retirement plan.[8] As stated in the above excerpt from the Court of Appeals' opinion, there is no "evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments."

The concept that "diverted" or "deflected" income is taxable to him who diverts or deflects it was broadly stated in *Hulbert v. Commissioner* (7 Cir., 1955) 227 F.2d 399, 401, a partnership case, as follows:

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[8]The rights here in question arose out of a contract resulting from arm's length negotiations between the principals. (Agreed Statement of Facts, ¶15, p. 7, I-R 42-2-9.) Those rights were defined, circumscribed and limited by that contract.

> The *power* to dispose of income is the equivalent of ownership of it and the *exercise of the power* to procure its payment to another is within the reach of the statute taxing income. . . . (401.)

In the instant case neither the partnership nor the individual physician-participant had *any such power.* It has been stipulated that the contributed funds "were paid *solely* to fund the retirement plan, and were *not otherwise available to Medical Group.*" (I-R 42.) According to the stipulation, Medical Group could not have received the funds in the form of current income; the essential element of a taxable diversion—an exercise of "the power to dispose of income"—was lacking.[7]

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2. THE DECISION BELOW DOES NOT APPLY ANY RULE RESPECTING THE TAXATION OF PARTNERSHIP INCOME

Because it determined the "diversion of income" issue in favor of respondent, the Court of Appeals found it unnecessary to reach the partnership income issues which the government sought to inject into this case. The court stated:

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[7]Despite its narrow and unusual facts, the government extravagantly contends that this case renders *Lucas v. Earl* "an empty admonition" and suggests in the same vein that the physicians here have managed to "immunize" themselves from taxation (Pet., 7). On the contrary, as the Court of Appeals pointed out:

> The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and *upon whom.* Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts, taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. (Pet., App. B, 35)

> Because we hold that neither the partnership as an entity nor the partners as individuals realized taxable income, we find it unnecessary to choose between the "entity" and "conduit" approaches, and this opinion is not to be read as adopting either of them.
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> (Pet., App. B, 37.)

Inasmuch as the partnership income issues were never reached, the court's decision has no significance in that area of the law, and cannot be in "conflict" with numerous partnership cases as contended by the government.

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3. THE DECISION BELOW HAS NO SIGNIFICANCE WITH RESPECT TO THE TAXATION OF DEFERRED COMPENSATION ARRANGEMENTS GENERALLY.

Contrary to the government's third argument, this decision cannot circumvent or frustrate Section 401 pertaining to qualified retirement plans established by *employers* for *employees*, because this case involves independent contractors, not employers and employees. Moreover, tax deferment on sums contributed to pension trusts is not confined to *qualified* trusts. In non-qualified trusts for employees, if the rights of beneficiaries are, as in this case, contingent and forfeitable at the time the contributions are made, the sums contributed are not currently taxable. Reg. 1.402(b)-1(a). On the contrary, such sums become taxable only upon distribution by the trust. This appears from the last sentence of Section 402(b) of the Internal Revenue Code (as it read before 1964):

> The amount actually distributed or made available to any distributee by any such trust shall be

taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities).

Thus, the decision in this case is in accord with the treatment of other nonqualified trusts.

The government's petition goes so far as to say that "Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer." (Pet., 13.) Like the other arguments in the petition, this *ignores the very basis of the decision in this case.* The sums paid into the trust *were not otherwise available* to Permanente and hence were not partnership income which it "chose to defer."

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4. "ADMINISTRATIVE IMPORTANCE" IS NOT A GROUND FOR CERTIORARI

The petition's fourth argument is merely that this case involves a substantial amount of disputed tax and a large number of Kaiser-related physicians. (The 568 pending cases are presumably those of the physician-partners who provided medical service to Kaiser members during 1960-63, through Permanente and other medical partnerships in the Kaiser service areas of California and Oregon.) No fundamental income tax principles are shaken by the decision below; that decision is entirely consistent with the existing law; and the undoubted administrative burden which the government has generated by bringing these cases is surely not a ground for certiorari.

CONCLUSION

In summary, this case does not "impair the integrity of any "cornerstone in the structure of the income tax law." According to the agreed statement of facts, Permanente did not "deflect" income to the trust. The payments which Kaiser made to the trust, and which are the subject of this lawsuit, ". . . were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] or to the individual members or employees thereof." The decision of the court below, that although respondents were partners they were not taxable in the year of contribution, is of little, if any, precedential value, except, of course, in the cases of other physicians who are participants in the same retirement plan or in several other identical plans funded by Kaiser.

We respectfully submit that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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